Legislative Audit Division

State of Montana

Report to the Legislature

December 2004

Financial-Compliance Audit

For the Two Fiscal Years Ended June 30, 2004

Montana State Fund

A Component Unit of the State of Montana

This is our financial-compliance audit report on the Montana State Fund for the two fiscal years ending June 30, 2004. The objectives of our financial-compliance audit included determining if the Montana State Fund's financial statements presented fairly its financial position and results of operations at and for the period ending June 30, 2004, with comparative totals at and for the period ending June 30, 2003.

We tested the Montana State Fund's compliance with state laws that have a direct and material impact on the financial statements. We also completed additional compliance testing with applicable laws and regulations as part of this financial-compliance audit.

This report contains no recommendations.

Direct comments/inquiries to:
Legislative Audit Division
Room 160, State Capitol
PO Box 201705
Helena MT 59620-1705

04-05

Help eliminate fraud, waste, and abuse in state government. Call the Fraud Hotline at 1-800-222-4446 statewide or 444-4446 in Helena.

FINANCIAL-COMPLIANCE AUDITS

Financial-compliance audits are conducted by the Legislative Audit Division to determine if an agency's financial operations are properly conducted, the financial reports are presented fairly, and the agency has complied with applicable laws and regulations. In performing the audit work, the audit staff uses standards set forth by the American Institute of Certified Public Accountants and the United States Government Accountability Office. Financial-compliance audit staff members hold degrees with an emphasis in accounting. Most staff members hold Certified Public Accountant (CPA) certificates.

Government Auditing Standards, the Single Audit Act Amendments of 1996 and OMB Circular A-133 require the auditor to issue certain financial, internal control, and compliance reports. This individual agency audit report is not intended to comply with these reporting requirements and is therefore not intended for distribution to federal grantor agencies. The Legislative Audit Division issues a statewide biennial Single Audit Report which complies with the above reporting requirements. The Single Audit Report for the two fiscal years ended June 30, 2005, will be issued by March 31, 2006. The Single Audit Report for the two fiscal years ended June 30, 2003, was issued on March 23, 2004. Copies of the Single Audit Report can be obtained by contacting:

Single Audit Coordinator
Office of Budget and Program Planning
State Capitol
Helena MT 59620
Phone (406) 444-3616

Legislative Audit Division
Room 160, State Capitol
PO Box 201705
Helena MT 59620-1705

LEGISLATIVE AUDIT DIVISION

Scott A. Seacat, Legislative Auditor
John W. Northey, Legal Counsel

Deputy Legislative Auditors:
Jim Pellegrini, Performance Audit
Tori Hunthausen, IS Audit & Operations
James Gillett, Financial-Compliance Audit

December 2004

The Legislative Audit Committee
of the Montana State Legislature:

This is our report on the financial-compliance audit of the Montana State Fund, a component unit of the State of Montana, for the two fiscal years ended June 30, 2004, and 2003. The objectives of this audit include determining if the financial statements for fiscal year 2003-04, with comparative financial amounts for fiscal year 2002-03, present fairly the Montana State Fund's financial position at June 30 for each fiscal year and the results of its operation for the two fiscal years then ended. We also tested compliance with laws and regulations related to operations of the Montana State Fund.

We made no recommendations to Montana State Fund in the current and prior audit reports. On page A-1, you will find the Independent Auditor's Report followed by the Management Discussion and Analysis, the financial statements and accompanying notes. The Management Discussion and Analysis is supplementary information required by the Governmental Accounting Standards Board. As disclosed in the Independent Auditor’s Report, we did not audit the information and express no opinion on it. We issued an unqualified opinion on the financial statements, which means the reader can rely on the information presented.

Montana State Fund is a workers' compensation insurance company established by the state of Montana. It is a nonprofit, quasi-public entity that provides Montana employers with an option for workers' compensation and occupational disease insurance. Montana State Fund is governed by a seven-member board of directors appointed by the Governor. State law separates funding sources for claims incurred before July 1, 1990 (Old Fund) and those incurred on or after July 1, 1990 (New Fund).

Montana State Fund management must set premium rates at amounts sufficient, when invested, to carry the estimated cost of all claims to maturity, to meet the reasonable expenses of conducting the business of the New Fund, and to maintain an excess of surplus over the amount produced by the National Association of Insurance Commissioners' risk-based capital requirements for a casualty insurer. The Old Fund costs are currently funded by investment earnings. The investments of the Montana State Fund are managed by the Montana Board of Investments and invested according to policies established in law.

Montana State Fund’s response to our audit is on page B-1. We thank the Montana State Fund staff for their cooperation and assistance during the audit.

Respectfully submitted,

(Signature on File)

Scott A. Seacat
Legislative Auditor

Room 160, State Capitol Building PO Box 201705 Helena, MT 59620-1705
Phone (406) 444-3122 FAX (406) 444-9784 E-Mail lad@state.mt.us

Appointed and Administrative Officials

Montana State Fund	Laurence Hubbard	President/CEO
	Mark Barry	Vice President, Corporate Support
	Layne Kertamus	Vice President, Insurance Operations
	Peter Strauss	Vice President, Insurance Operations Support
	Nancy Butler	General Counsel

State Fund Board of Directors		Term Expires
	Herb Leuprecht	2005
	Ed Henrich	2007
	Mardi Madsen	2007
	Derek Scoble	2007
	Derek Grewatz	2005
	Jack Morgenstern	2005
	Mark Cole	2005

For additional information concerning the Montana State Fund, contact Laurence Hubbard, President/CEO, at:

5 South Last Chance Gulch
Helena MT 59601
(406) 444-6501

Members of the audit staff involved in this audit were Pearl M. Allen, Jennifer Erdahl, Geri Hoffman, Alexa O'Dell, and Sonia Powell.

LEGISLATIVE AUDIT DIVISION

Scott A. Seacat, Legislative Auditor
John W. Northey, Legal Counsel

Deputy Legislative Auditors:
Jim Pellegrini, Performance Audit
Tori Hunthausen, IS Audit & Operations
James Gillett, Financial-Compliance Audit

INDEPENDENT AUDITOR'S REPORT

The Legislative Audit Committee
of the Montana State Legislature:

We have audited the accompanying Statements of Net Assets, New Fund and Old Fund, of the Montana State Fund, a component unit of the state of Montana, as of June 30, 2004, and 2003, and the related Statements of Revenues, Expenses, and Changes in Fund Net Assets, New Fund and Old Fund, and the Statements of Cash Flows, New Fund and Old Fund, for the fiscal years then ended. The information contained in these financial statements is the responsibility of the Montana State Fund's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Montana State Fund as of June 30, 2004, and 2003, and the results of its operations and its cash flows for the fiscal years then ended in conformity with accounting principles generally accepted in the United States of America.

The accompanying Management Discussion and Analysis is not a required part of the financial statements but is supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Respectfully submitted,

(Signature on File)

James Gillett, CPA
Deputy Legislative Auditor

November 15, 2004

Room 160, State Capitol Building PO Box 201705 Helena, MT 59620-1705
Phone (406) 444-3122 FAX (406) 444-9784 E-Mail lad@state.mt.us

Montana State Fund's Management Discussion and Analysis, Financial Statements and Notes

Montana State Fund
(A Component Unit of the State of Montana)
Management Discussion and Analysis
June 30, 2004 and 2003

Description of Business

The Montana State Fund (MSF) is a nonprofit, quasi-public entity established under Title 39, Chapter 71 of the Montana Code Annotated (MCA). MSF provides Montana employers with an option for workers' compensation and occupational disease insurance and guarantees available coverage for all employers in Montana. MSF is governed by a seven member Board of Directors appointed by the Governor. MSF is attached to the State of Montana, Department of Administration for administrative purposes only.

During the 1990 Montana Special Legislative Session, legislation passed establishing separate funding and accounts for claims of injuries resulting from accidents occurring before July 1, 1990, referred to as the Old Fund, and claims occurring on or after July 1, 1990, referred to as MSF.

MSF functions as an autonomous insurance entity supported solely from its own revenues. All assets, debts, and obligations of MSF are separate and distinct from assets, debts, and obligations of the State of Montana. No State general fund money is used for MSF operations. If MSF is dissolved by an act of law, the money held by MSF is subject to the disposition provided by the legislature enacting the dissolution with due regard given to obligations incurred and existing (Section 39-71-2322, MCA). MSF administers and manages the claims remaining in the Old Fund for the State of Montana and is the administering entity for recording the financial activity related to receipt and disbursement of funds held in the Old Fund.

MSF financial statements are presented as a component unit in the State of Montana Comprehensive Annual Financial Report. MSF uses the accrual basis of accounting, as defined by generally accepted accounting principles, for its workers' compensation insurance operations. Under the accrual basis, MSF records revenues in the accounting period earned, if measurable, and records expenses in the period incurred, if measurable.

Financial Position – MSF

MSF's financial position weakened from fiscal year 2003 to 2004. Total net assets decreased from $163.1M (million) in 2003 to $142.8M in 2004, a reduction of 12.5%. This reduction is primarily due to the impact of the $38.7M change in estimated claims payable, an increase of 9.37% from 2003 to 2004. The estimated claims payable increased primarily due to reserve strengthening of $19.9M on prior year losses. Contributing to the reduction in net assets are increases in benefit payments and operating expenses. The reduction, however, is partially offset by premium growth of 18.3%. Total net earned premium in 2004 is $139.4M, up from $117.8M in 2003. The following discussion will explain the reasons for these changes and provide additional background to MSF's financial position.

Assets

At June 30, 2004, total invested assets (cash and cash equivalents, long term fixed securities, and equities) are $602.8M. This is an increase of $28.3M or 4.9% of the invested assets held at June 30, 2003. In 2004, the book value of equity securities decreased to $68.4M from $79.0M in 2003 from the sale of equity securities during the course of the year to maintain holdings in equities of approximately 12% of total investments. In 2004 the equity security carrying value, which includes a $3.7M unrealized gain, is $72.1M, or 12.0% of MSF's total cash and investments. In 2003 equity securities' carrying value, which includes a $9.0M unrealized loss, is $70.0M which is 12.2% of MSF's total cash and investments. Total bonds in 2004 have grown to $509.9M up from $472.4M in 2003. This results in a bond to total cash and investment ratio of 84.6% in 2004 compared to 82.2% in 2003. Cash and cash equivalents are classified as current assets and decreased from $32.1M in 2003 to $20.7M in 2004. Most of this decrease is attributed to a decrease in MSF's portion of the short-term investment pool (STIP).

Under the provisions of the state constitution, MSF's invested assets are managed by the Montana Board of Investments (BOI). The BOI has, by a Securities Lending Authorization Agreement, authorized the custodial bank to lend MSF's securities to broker-dealers and other entities with a simultaneous agreement to return the collateral for the same securities in the future. State Street Bank was appointed the BOI's custodial bank on December 1, 1993. During the period the securities are on loan, BOI receives a fee and the bank must initially receive collateral equal to 102% of the market value of the securities on loan and must maintain collateral equal to but not less than 100% of the market value of the loaned security. BOI retains all rights of ownership during the loan period. The total collateral held at the end of fiscal year 2004 is $141.0M compared to $31.0M in 2003, all of which is classified as a short-term asset with an offsetting short-term liability.

Net premiums receivable, at $5.2M in 2004, increased from prior year's net premiums receivable of $4.2M. Net receivables are expected to be collectible within one year. Other receivables for fiscal year 2004 consist of interest receivables of $7.5M and notes receivable of $142K (thousand) of which $37K is long term. Other receivables for fiscal year 2003 consist of interest receivables of $6.6M and notes receivable of $199K, of which $73K is long term.

Equipment increased slightly from prior year with fiscal year 2004 acquisitions of $523K offset by retirements of $357K. Acquisitions consist primarily of information technology equipment, which also comprises approximately half of the retirements, with vehicles and office equipment making up the remaining half. This compares to fiscal year 2003 acquisitions of $566K offset by retirements of $691K. Accumulated depreciation increased $82K from year to year due to fiscal year 2004 depreciation expense of $521K and allocated depreciation expense of $87K to Old Fund offset by retirements of $525K. Depreciation expense in fiscal year 2003 totaled $533K with the Old Fund allocation of $13K offset by retirements of $603K.

In fiscal year 2004 intangible assets decreased to $1.1M from $2.1M in 2003. Fiscal year 2004 acquisitions are $503K offset by amortization expense of $1.1M and allocated amortization expense of $90K to Old Fund. Fiscal year 2003 acquisitions were $206K offset by amortization expense of $1.1M and allocated amortization of $121K to Old Fund.

Other assets are comprised of prepaid expenses and other advances, property held in trust and deferred acquisition costs. Other assets decreased to $2.0M in 2004 from $2.3M in 2003, primarily due to a decrease in deferred acquisition costs, attributable to a decrease in estimated unearned premium in 2004 over 2003.

Liabilities

Tillinghast-Towers Perrin, an independent actuarial firm, prepares an actuarial study used to estimate liabilities and the ultimate cost of settling claims reported but not settled and claims incurred but not reported (IBNR) for MSF as of June 30, 2004 and June 30, 2003. Tillinghast-Towers Perrin provides a range of potential costs associated with reported claims, the future development of those claims and IBNR. MSF management has selected the best estimate within that range as the estimated claims payable, consisting of unpaid claims and claim adjustment expenses, for fiscal years 2004 and 2003. The estimated claims payable is presented undiscounted, net of estimated reinsurance recoverable, at $452.1M and $413.4M, as of June 30, 2004 and June 30, 2003, respectively.

The estimated claims payable increased $38.7M from 2003 to 2004 primarily due to reserve strengthening of $19.9M on prior year claims. The estimated claims payable also includes $2.6M for contingencies due to recent court decisions. MSF currently has no knowledge of any significant environmental or asbestos claims that would contribute to this estimate. The current portion of the estimated claims payable, or the portion of the payable expected to be paid within the next twelve months are $99.7M and $87.6M for fiscal years 2004 and 2003 respectively. The balance of the estimated claims payable, classified as long-term, are $352.4M for fiscal year 2004 and $325.8M for fiscal year 2003.

Property held in trust increased to $8.5M in 2004, up from $4.5M in 2003 due to the funds withheld account requirement of MSF's aggregate stop loss reinsurance treaty. The three-year treaty, effective July 1, 2002, includes a provision for MSF to maintain a funds withheld account in the amount of $2.6M for fiscal year 2004 with interest accruing at 6.5%, totaling $173K at June 30, 2004. In fiscal year 2003, MSF's aggregate stop loss reinsurance treaty included a provision for MSF to maintain a funds withheld account in the amount of $2.1M with interest accruing at 6.5%, totaling $143K at June 30, 2003.

Deferred revenue increased to $6.0M in 2004 from $203K in 2003 due to increased premiums and more policy billings during the fiscal year. The entire balance is classified as short-term since the billings are for one year or less.

As discussed above in the *Assets* section, the BOI has a Securities Lending Authorization Agreement to lend MSF's securities to broker-dealers and other entities with a simultaneous agreement to return the collateral for the same securities in the future. The total collateral owed at the end of fiscal year 2004 is $141.1M compared to $31.0M in 2003, all of which is classified as a short-term liability with an offsetting short-term asset.

Other MSF payables consist of accounts payable and payables for leases and compensated absences. Accounts payable experienced the greatest change from prior year and increased to $8.2M at June 30, 2004, up from $7.0M at June 30, 2003. This increase is attributable to end of year accruals for medical benefit payments.

Net Assets

During fiscal year 2004, net assets decreased from $163.1M in 2003 to $142.8M in 2004 due to a net loss of $20.3M. Net assets are restricted by the sum of capital assets which amount to $2.4M in 2004 compared to $2.8M in 2003.

Results of Operations – MSF

Net Premiums Earned

Net premiums earned in fiscal year 2004 totaled $139.4M, up from $117.8M in 2003, an 18.3% increase. The increase is driven by a significant number of new policies and increased pricing on renewing policies. MSF writes other states coverage for Montana state-domiciled insureds that have locations in states other than Montana. Other states coverage assumed premium for fiscal years 2004 and 2003 is $2.0M and $1.6M respectively.

Investment Income

Investment income for fiscal year 2004 was $15.0M as compared to $46.2M for fiscal year 2003. The $31.2M decrease in investment income is wholly attributable to the change in unrealized gains and losses on invested assets. In fiscal year 2004, unrealized losses on invested assets are ($11.6M) including unrealized gains on equities of $12.8M offset by unrealized losses on fixed income securities of ($24.4M). In fiscal year 2003, MSF had unrealized gains on invested assets of $19.3M, with unrealized gains on fixed security investments of $18.5M and unrealized gains on equity holdings of $800K. Net investment earnings on all other investment activity including interest earnings, realized gains or losses on sales of investments and net securities lending activity for fiscal year 2004 was $27.8M as compared to $29.0M in fiscal year 2003. This $1.2M decrease can be attributed to investments made in lower yielding investments available in the investment markets.

Net realized gains decreased to $1.8M in 2004, down from $3.1M in 2003 primarily due to decreased sales of bonds during FY 2004. Net realized losses decreased to $742K in 2004, down from $987K in 2003. Securities lending income increased to $939K in 2004 from $751K in 2003. The associated expense also increased to $846K in 2004 from $674K in 2003.

Operating Expenses

Claim benefits to injured employees in 2004 are $139.2M on an incurred basis compared to $152.0M in 2003, resulting in a decrease of $12.8M. The decrease is driven primarily by the change in the estimated claims liability. In 2004, the estimated claims liability increased by $38.7M compared to $67.0M in 2003 and is discussed in more detail in the *Liabilities* section above. Both medical and indemnity costs increased in 2004 over 2003. Medical payments increased 17.8% and indemnity payments increased 18.8%.

Personal services increased from $13.8M in 2003 to $15.4M in 2004, an 11.2% increase. Commission increased $1.2M in fiscal year 2004 due to increased commission payments on higher premium levels. Contracted services increased $1.6M in fiscal year 2004 due primarily to higher consulting and professional services and audit fees. Supplies and materials decreased to $745K in fiscal year 2004 due to lower purchases of minor equipment and software.

Depreciation expense for fiscal year 2004 decreased $13K from fiscal year 2003 and amortization expense for fiscal year 2004 increased $72K from fiscal year 2003.

Other operating expenses increased to $3.1M in 2004 from $1.4M, a change of $1.7M. Approximately 62% of this change is due to increased deferred acquisition cost amortization and 32% due to increased bad debt expense. Other operating expenses for 2004 also include funds withheld interest of $173K.

<u>Other Nonoperating Revenue and Expenses</u>

In fiscal year 2004, MSF received $91K in royalty income for the sale of in-house developed software compared to $98K in 2003.

Other transactions impacting surplus include dividends paid to policyholders, which totaled $1.9M in 2004 and $3.0M in 2003. In fiscal year 2003, House Bill Number 363, enacted by the 2003 Montana Legislature, changed existing law regulating the Old Fund transfer of surplus, including changing the recipient of the transfer from New Fund to the General Fund of the State of Montana. For additional discussion on the fiscal year 2003 transfer, see *Other Nonoperating Revenue and Expenses* in the *Results of Operations – Old Fund* section.

<u>Change in Net Assets</u>

Results of operations for fiscal year 2004 showed a decrease in loss of $28.4M resulting from an operating loss of ($34.7M) compared to an operating loss for fiscal year 2003 of ($63.1M). At the same time non-operating revenue for fiscal year 2004 was $14.4M compared to non-operating revenue of $45.5M for fiscal year 2003 resulting in a decrease of non-operating revenue of ($31.1M). The change in net assets for fiscal 2004, results of operations plus non-operating revenue, is ($20.3M). The change in net assets for fiscal year 2003 is ($17.6M). Fiscal year 2004's change in net assets decreased from fiscal year 2003 by ($2.7M).

<u>Financial Position – Old Fund</u>

Old Fund's financial position has weakened from fiscal year 2003 to 2004. Old Fund's primary source of income is investment income that helps to maintain adequate reserve levels to fund claims dated prior to July 1, 1990. Fiscal year 2004 experienced significantly lower investment income plus an increase in the estimated amount to be paid on the remaining open Old Fund claims driven by increasing medical costs on those claims. The following discussion will provide additional background to Old Fund's financial position.

Assets

Old Fund's investment portfolio consists of long-term bonds, which decreased to \$69.2M in fiscal year 2004 from \$81.9M in fiscal year 2003. The bond to total cash and investment ratio for 2004 is 94.4% compared to 94.5% for 2003. As reserve levels decrease and funds are transferred out of Old Fund, monies to be invested decrease. For further explanation, see the estimated claims payable and transfer discussions below in the *Liabilities* and *Other Nonoperating Revenue and Expenses* sections.

Interest receivable for the year ended June 30, 2004 is \$1.0M compared to \$1.3M for year ended June 30, 2003. Net accounts receivable consists of medical overpayments and remaining receivables from the Old Fund Liability Tax. Net accounts receivable due from external sources for 2004 is \$64K, down from \$98K in 2003.

Old Fund is also a part of the BOI's Securities Lending Authorization Agreement and therefore has securities lending collateral with an offsetting securities lending liability at year end. The balance for 2004 is \$13.2M and the balance for 2003 is \$6.1M.

Liabilities

An actuarial study prepared by Tillinghast-Towers Perrin for the Old Fund as of June 30, 2004 and June 30, 2003, is used to estimate liabilities and the ultimate cost of settling claims that have been reported, but not settled, and claims that have been incurred, but not reported (IBNR). Tillinghast-Towers Perrin provides a range of potential costs associated with reported claims, the future development of those claims and IBNR. Tillinghast also provides an estimate of these liabilities at present value to reflect investment earnings of the assets invested to pay claims. MSF management has selected the best estimate within that range as the estimated claims payable, consisting of unpaid claims and claim adjustment expenses, for fiscal years 2004 and 2003. As of June 30, 2004, the undiscounted estimated claims payable is \$108.5M and is presented at net present value of \$80.8M discounted at 5.25%. As of June 30, 2003, the undiscounted estimated claims payable is \$113.2M and is presented at net present value of \$80.9M discounted at 5.25%. Although over \$11.6M in claim benefit payments were made during fiscal year 2004, the amount estimated to be paid remained virtually the same, driven by an estimated increase in medical costs to be paid on the remaining claims.

Reserve levels will continue to decrease with time, since Old Fund has no new claims but continues to pay on already-existing claims. As reserve levels decrease, so will the need to fund those levels resulting in decreasing investment needs over time. This trend is evident with the lower 2004 estimated claims payable and investment balances when compared to 2003. The short-term portions of the estimated claims payable are \$14.4M and \$10.2M for fiscal years 2004 and 2003, respectively. The long-term portions of the payable are $66.4M and $70.7M for fiscal years 2004 and 2003, respectively.

Net Assets

During fiscal year 2004, total net assets decreased from $6.2M in 2003 to $(7.4M) in 2004 due to a net loss of ($13.6M). The negative net asset balance is the direct result of the transfers made from the Old Fund to the General Fund mandated by HB363, see the discussion under the Other Nonoperating Revenue and Expenses in the Results of Operations – Old Fund section. The net assets also include an unrealized loss of ($3.8M) for fiscal year 2004 compared to an unrealized gain of $3.4M for fiscal year 2003. This does not indicate that the Old Fund does not have adequate financial resources to satisfy current claims obligations. Applying the current actuarially estimated payout pattern of the Old Fund there is sufficient invested assets to meet its obligations until the year 2014. At that time current law would require the General Fund to satisfy all outstanding claims when the Old Fund has liquidated all financial resources and cannot meet its obligations. Net assets are restricted by the estimated amount of the next fiscal year's transfer to the State of Montana, General Fund. The estimated transfer amount for 2004 is $0.00 representing no transfer to be paid in 2005 compared to $816K in 2003 which was paid in 2004.

Results of Operations – Old Fund

Investment-Related Revenue

In fiscal year 2004 there was an investment loss of ($105K) compared to investment income of $8.9M in fiscal year 2003. The decrease is due to a lower interest income from bonds and an unrealized loss on investments. In fiscal year 2004 the unrealized loss was ($3.8M) compared to an unrealized gain of $3.4M in fiscal year 2003.

Other Nonoperating Revenue and Expenses

House Bill Number 363 (HB 363) was enacted by the 2003 Montana Legislature and changed the existing law regulating the Old Fund transfer of surplus. HB 363 removed the 10% contingency reserve requirement for the Old Fund and transfers the excess available funds from Old Fund to the State of Montana General Fund. In fiscal year 2004, $816K was transferred from Old Fund to the State of Montana, General Fund. In fiscal year 2003 the amount transferred from Old Fund to the State of Montana, General Fund was $22.2M.

Operating Expenses

State law (Section 39-71-2352, MCA) requires MSF to separately determine and account for administrative expenses and benefit payments for claims for injuries resulting from accidents occurring before July 1, 1990 (Old Fund) from those occurring on or after July 1, 1990 (MSF). The law also limits annual administrative costs of claims associated with the Old Fund to $1.25M for both fiscal years 2004 and 2003. MSF allocated $1.25M in administration costs to the Old Fund in fiscal years 2004 and 2003. The Old Fund has a $1.0M obligation to MSF in unrecovered administrative costs incurred in fiscal years 2004 and prior. MSF intends to recover this amount in future years where the cost of administering the Old Fund is less than the statutorily permitted $1.25M.

Change in Net Assets

The change in net assets for fiscal year 2004 is a reduction of $13.6M compared to a decrease of $18.6M in fiscal year 2003. The primary reason for this decrease is the increased transfer of excess surplus (see related discussion in *Other Nonoperating Revenue and Expenses* above) as well as increased benefit payments and lower investment income. The decreases in net assets have left a deficit in the net assets account of ($7.4M).

MONTANA STATE FUND - NEW FUND
STATEMENT OF NET ASSETS
Montana State Fund is a component unit of the State of Montana

JUNE 30,	2004	2003
ASSETS		
Current Assets		
Cash and cash equivalents	20,685,046	32,140,643
Receivables, net	12,823,616	10,875,720
Due from primary government	997	1,597
Due from component units	531,041	185,117
Securities lending collateral	141,060,425	30,968,721
Other assets	2,038,048	2,347,602
Total Current Assets	177,139,173	76,519,400
Noncurrent Assets		
Investments	582,067,623	542,323,394
Notes and loans receivable	37,198	73,341
Equipment	3,135,509	2,970,105
Accumulated depreciation	(1,928,362)	(1,846,144)
Intangible assets	1,142,019	2,110,370
Total Noncurrent Assets	584,453,987	545,631,066
Total Assets	761,593,160	622,150,466
LIABILITIES		
Current Liabilities		
Accounts payable	8,156,787	6,959,896
Due to primary government	1,223,182	1,139,171
Due to component units	62,534	-
Estimated claims payable	99,731,000	87,603,000
Compensated absences	1,013,157	723,043
Lease payable	-	161,127
Securities lending liability	141,060,425	30,968,721
Deferred revenue	5,977,233	202,912
Property held in trust	8,513,185	4,498,097
Total Current Liabilities	265,737,503	132,255,967
Noncurrent Liabilities		
Estimated claims payable	352,384,000	325,797,000
Compensated absences	699,479	694,883
Lease payable	-	308,801
Total Noncurrent Liabilities	353,083,479	326,800,684
Total Liabilities	618,820,982	459,056,651
NET ASSETS		
Invested in capital assets, net of related debt	2,349,166	2,764,403
Unrestricted	140,423,012	160,329,412
Total Net Assets	142,772,178	163,093,815
Total Liabilities and Net Assets	761,593,160	622,150,466

The notes to the financial statements are an integral part of this statement.

MONTANA STATE FUND - NEW FUND
STATEMENT OF REVENUES, EXPENSES, and CHANGES IN FUND NET ASSETS
Montana State Fund is a component unit of the State of Montana

YEARS ENDED JUNE 30,	2004	2003
Net premiums earned	139,360,612	117,776,580
Operating Expenses		
Benefits and claims	139,232,097	151,964,040
Personal services	15,379,088	13,828,981
Contractual services	11,956,710	9,137,989
Supplies and materials	745,190	1,058,390
Depreciation	520,500	533,367
Amortization	1,144,444	1,072,431
Rent and utilities	229,056	212,547
Communications	1,178,257	938,603
Travel	181,419	208,188
Repair and maintenance	440,180	518,276
Interest expense		18,758
Other operating expenses	3,059,447	1,429,604
Total Operating Expenses	174,066,388	180,921,174
Operating Loss	(34,705,776)	(63,144,594)
Nonoperating Revenue (Expenses)		
Investment income	14,994,923	46,166,631
Gains on investments	1,845,426	3,112,888
Securities lending income	938,947	750,925
Losses on investments	(742,294)	(986,736)
Securities lending expense	(846,168)	(673,628)
Royalties	91,124	97,724
Penalties and interest	13,186	29,846
Payment from Old Fund	-	-
Payment to State of Montana	(10,218)	(1,288)
Loss on retirement of assets	(10,485)	(56,057)
Dividend expense	(1,909,856)	(2,949,597)
Other income	19,554	32,418
Total Nonoperating Revenue (Expense)	14,384,139	45,523,126
Change in Net Assets	(20,321,637)	(17,621,468)
Total Net Assets - Beginning	163,093,815	180,715,283
Total Net Assets - Ending	142,772,178	163,093,815

The notes to the financial statements are an integral part of this statement.

MONTANA STATE FUND - NEW FUND
STATEMENT OF CASH FLOWS
Montana State Fund is a component unit of the State of Montana

YEARS ENDED JUNE 30,	2004	2003
CASH FLOWS FROM OPERATING ACTIVITIES		
Receipts for premiums	148,065,720	120,604,417
Payments to suppliers for goods and services	(17,965,050)	(13,171,804)
Payments to employees	(14,913,111)	(13,856,547)
Cash payments for claims	(98,956,660)	(82,147,587)
Other operating receipts	(19,330)	164,507
Other operating payments	(1,909,856)	(2,949,597)
Net Cash Provided by (Used for) Operating Activities	14,301,713	8,643,389
CASH FLOWS FROM NONCAPITAL FINANCIAL ACTIVITIES		
Payment to State of Montana	(10,218)	(818)
Net Cash Provided by (Used for) Noncapital Financing Activities	(10,218)	(818)
CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES		
Acquisition of fixed assets	(1,458,613)	(571,838)
Proceeds from sale of fixed assets	125,278	20,436
Net Cash Used for Capital and Related Financing Activities	(1,333,335)	(551,402)
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchase of investments	(148,909,900)	(229,438,861)
Proceeds from sales or maturities of investments	97,157,279	202,398,236
Proceeds from securities lending transactions	938,947	750,925
Payments of security lending costs	(772,214)	(716,597)
Interest and dividends on investments	27,172,131	29,020,897
Net Cash Provided by (Used For) Investing Activities	(24,413,757)	2,014,600
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	(11,455,597)	10,105,769
CASH AND CASH EQUIVALENTS - JULY 1	32,140,643	22,034,874
CASH AND CASH EQUIVALENTS - JUNE 30	20,685,046	32,140,643

The notes to the financial statements are an integral part of this statement.

MONTANA STATE FUND - NEW FUND
STATEMENT OF CASH FLOWS
Montana State Fund is a component unit of the State of Montana

YEARS ENDED JUNE 30,	2004	2003
RECONCILIATION OF CHANGE IN NET ASSETS TO NET CASH PROVIDED BY (USED FOR) OPERATING ACTIVITIES		
Change in Net Assets	(20,321,637)	(17,621,468)
Adjustments to Reconcile Change in Net Assets to Net Cash Provided by (Used for) Operating Activities		
Depreciation	520,500	533,367
Amortization	1,144,444	1,072,431
Interest expense	-	18,758
Security lending costs	846,168	673,628
Security lending income	(938,947)	(750,925)
Interest on investment	(16,098,055)	(48,292,783)
Payment to State of Montana	10,218	1,288
Decrease (increase) in		
Accounts receivable	(1,013,293)	307,849
Due from component units	(345,324)	986,796
Notes receivable	36,143	(21,431)
Other assets	320,039	(618,991)
Increase (decrease) in		
Accounts payable	1,195,920	3,205,805
Due to primary government	146,418	(153,716)
Deferred revenue	5,774,321	(381,068)
Property held in trust	4,015,088	2,357,231
Estimated claims	38,715,000	67,000,000
Lease payable	-	178,480
Compensated absences	294,710	148,138
Total adjustments	34,623,350	26,264,857
Net Cash Provided by (Used for) Operating Activities	14,301,713	8,643,389

The notes to the financial statements are an integral part of this statement.

MONTANA STATE FUND - OLD FUND
STATEMENT OF NET ASSETS
Montana State Fund is a component unit of the State of Montana

JUNE 30,	2004	2003
ASSETS		
Current Assets		
Cash and cash equivalents	4,113,840	4,743,496
Receivables, net	1,089,275	1,281,843
Due from component units	62,534	-
Securities lending collateral	13,248,863	6,099,450
Total Current Assets	18,514,512	12,124,789
Noncurrent Assets		
Investments	69,215,594	81,902,359
Total Assets	87,730,106	94,027,148
LIABILITIES		
Current Liabilities		
Accounts payable	613,607	582,675
Due to primary government	1,387	1,889
Due to component units	531,041	185,117
Estimated claims payable	14,409,000	10,178,000
Compensated absences	-	63,226
Deferred revenue	-	-
Securities lending liability	13,248,863	6,099,450
Total Current Liabilities	28,803,898	17,110,357
Noncurrent Liabilities		
Estimated claims payable	66,369,000	70,722,000
Compensated absences	-	-
Total Noncurrent Liabilities	66,369,000	70,722,000
Total Liabilities	95,172,898	87,832,357
NET ASSETS		
Restricted	-	815,605
Unrestricted	(7,442,792)	5,379,186
Total Net Assets	(7,442,792)	6,194,791
Total Liabilities and Net Assets	87,730,106	94,027,148

The notes to the financial statements are an integral part of this statement.

MONTANA STATE FUND - OLD FUND
STATEMENT OF REVENUES, EXPENSES, and CHANGES IN FUND NET ASSETS
Montana State Fund is a component unit of the State of Montana

YEARS ENDED JUNE 30,	2004	2003
Operating Expenses		
Benefits and claims	11,558,899	4,273,383
Personal services	21,126	-
Contractual services	1,024,608	1,078,828
Depreciation	86,639	12,976
Amortization	90,220	120,653
Other operating expenses	353,838	301,211
Total Operating Expenses	13,135,330	5,787,051
Operating Loss	(13,135,330)	(5,787,051)
Nonoperating Revenue (Expenses)		
Investment income	(104,724)	8,857,998
Gains on investments	335,941	632,698
Securities lending income	118,563	187,399
Losses on investments	(479)	(47,840)
Securities lending expense	(104,076)	(167,089)
Payment to State of Montana	(815,605)	(22,267,907)
Payment to New Fund	-	-
Liability tax revenue	68,127	455
Total Nonoperating Revenue (Expenses)	(502,253)	(12,804,286)
Change in Net Assets	(13,637,583)	(18,591,337)
Total Net Assets - Beginning	6,194,791	24,866,024
Prior Period Adjustment	-	(79,896)
Total Net Assets - Ending	(7,442,792)	6,194,791

The notes to the financial statements are an integral part of this statement.

MONTANA STATE FUND - OLD FUND
STATEMENT OF CASH FLOWS
Montana State Fund is a component unit of the State of Montana

YEARS ENDED JUNE 30,	2004	2003
CASH FLOWS FROM OPERATING ACTIVITIES		
Payments to suppliers for goods and services	(1,294,235)	(1,845,955)
Payments to employees		-
Cash payments for claims	(11,656,177)	(13,897,538)
Collection of payroll taxes	37,881	1,184
Net Cash Used for Operating Activities	(12,912,531)	(15,742,309)
CASH FLOWS FROM NONCAPITAL FINANCIAL ACTIVITIES		
Payment to State of Montana	(815,605)	(22,267,907)
Payment to New Fund		-
Net Cash Used for Noncapital Financing Activities	(815,605)	(22,267,907)
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchase of investments	(15,568,930)	(6,397,094)
Proceeds from sales or maturities of investments	24,292,805	37,214,538
Proceeds from securities lending transactions	118,563	187,399
Payments of security lending costs	(95,863)	(185,807)
Interest and dividends on investments	4,351,905	6,529,002
Net Cash Provided by Investing Activities	13,098,480	37,348,038
NET DECREASE IN CASH AND CASH EQUIVALENTS	(629,656)	(662,178)
CASH AND CASH EQUIVALENTS - JULY 1	4,743,496	5,405,674
CASH AND CASH EQUIVALENTS - JUNE 30	4,113,840	4,743,496

The notes to the financial statements are an integral part of this statement.

MONTANA STATE FUND - OLD FUND
STATEMENT OF CASH FLOWS
Montana State Fund is a component unit of the State of Montana

YEARS ENDED JUNE 30,	2004	2003
RECONCILIATION OF CHANGE IN NET ASSETS TO NET CASH USED FOR OPERATING ACTIVITIES		
Change in Net Assets	(13,637,583)	(18,591,337)
Adjustments to Reconcile Change in Net Assets to Net Cash Used for Operating Activities		
Security lending costs	104,076	167,089
Security lending income	(118,563)	(187,399)
Interest on investment	(230,738)	(9,442,855)
Payment to State of Montana	815,605	22,267,907
Payment to New Fund		-
Prior period adjustment for payroll taxes		(79,896)
Decrease (increase) in		
Accounts receivable	34,290	696,072
Due from primary government	(62,534)	730
Increase (decrease) in		
Accounts payable	(40,506)	370,508
Due to component units	345,422	(332,288)
Deferred revenue	-	(610,840)
Estimated claims	(122,000)	(10,000,000)
Total adjustments	725,052	2,849,028
Net Cash Used for Operating Activities	(12,912,531)	(15,742,309)

The notes to the financial statements are an integral part of this statement.

Montana State Fund
(A Component Unit of the State of Montana)
Notes to Financial Statements
June 30, 2004 and 2003

1. Summary of Significant Accounting Policies

Description of Business

The Montana State Fund (MSF) is a nonprofit, quasi-public entity established under Title 39, chapter 71 of the Montana Code Annotated (MCA). MSF provides Montana employers with an option for workers' compensation and occupational disease insurance and guarantees available coverage for all employers in Montana. MSF is governed by a seven member Board of Directors appointed by the Governor. MSF is attached to the State of Montana, Department of Administration for administrative purposes only.

During the 1990 Montana Special Legislative Session, legislation passed establishing separate funding and accounts for claims of injuries resulting from accidents occurring before July 1, 1990, referred to as the Old Fund, and claims occurring on or after July 1, 1990, referred to as MSF.

MSF functions as an autonomous insurance entity supported solely from its own revenues. All assets, debts, and obligations of MSF are separate and distinct from assets, debts, and obligations of the State of Montana. If MSF is dissolved by an act of law, the money in MSF is subject to the disposition provided by the legislature enacting the dissolution with due regard given to obligations incurred and existing (Section 39-71-2322, MCA). MSF administers and manages the claims remaining in the Old Fund for the State of Montana and is the administering entity for recording the financial activity related to receipt and disbursement of an Old Fund Liability Tax (see Note 4). No State general fund money is used for MSF operations.

MSF financial statements are presented as a component unit in the State of Montana Comprehensive Annual Financial Report. The fiscal year 2004 and 2003 financial statements are presented in conformance with Governmental Accounting Standards Board Statement 34 which is a comparable format to the State of Montana Comprehensive Annual Financial Report.

Basis of Accounting

MSF uses the accrual basis of accounting, as defined by generally accepted accounting principles, for its workers' compensation insurance operations. Under the accrual basis, MSF records revenues in the accounting period earned, if measurable, and records expenses in the period incurred, if measurable.

<u>Cash and Cash Equivalents</u>

Cash balances include demand deposits with the State Treasury. MSF also participates in the Montana Board of Investments Short Term Investment Pool (STIP). STIP balances are highly liquid investments with maturities of 397 days or less with the exception of securities having rate reset dates. There are no legal risks that the Montana Board of Investments (BOI) is aware of regarding any STIP investments. The STIP portfolio is carried at amortized cost or book value with market value approximating cost. MSF's STIP balance of $18.2M as of June 30, 2004 represents 1.23% of the total STIP. The Old Fund STIP balance of $3.6M as of June 30, 2004 represents 0.25% of the total STIP. MSF's STIP balance of $29.9M as of June 30, 2003 represents 2.11% of the total STIP. The Old Fund STIP balance of $4.7M as of June 30, 2003 represents 0.33% of the total STIP.

The STIP investments' credit risk is measured by investment grade ratings given individual securities. The BOI's policy requires that STIP investments have the highest rating in the short-term category by one and/or any Nationally Recognized Statistical Rating Organizations (NRSRO). The four NRSRO's include Standard and Poor's, Moody's Investors Service, Fitch, Inc. and Dominion Bond Rating Service Ltd.

Asset-backed securities constitute 63.58% of the BOI's total STIP portfolio as of June 30, 2004. Asset-backed securities have less credit risk than do securities not backed by pledged assets. Market risk for asset-backed securities is the same as market risk for similar non asset-backed securities. Asset-backed securities constitute 51.63% of the Board of Investment's total STIP portfolio as of June 30, 2003.

Variable rate (floating rate) securities make up 34.12% of the BOI's total STIP portfolio as of June 30, 2004. Variable rate securities make up 44.42% of the BOI's total STIP portfolio as of June 30, 2003. While variable rate securities have credit risk identical to similar fixed rate securities, their market risk (income) is more sensitive to interest rate changes. However, the market risk (value/price) may be less volatile than fixed rate securities because their value will usually remain at or near par as a result of their interest rates being periodically reset to maintain a current market yield.

<u>Investments</u>

In addition to STIP investments, MSF invests in long-term securities with the BOI. Under the provisions of the state constitution, MSF's invested assets are managed by the BOI. Securities are stated at fair value as defined and required by Governmental Accounting Standards Board (GASB) Statement Number 31, "Accounting and Financial Reporting for Certain Investments and for External Investment Pools". Premiums and discounts are amortized using the straight-line method over the life of the securities. Net unrealized gains or losses on securities are included in net income in accordance with GASB 31.

MSF investments are classified in risk Category 1 or as Not Categorized under State of Montana standards. Risk category 1 includes investments that are insured or registered, or securities held by the BOI or its agent in the BOI's name. Not Categorized includes investments held by broker-dealers under securities loans with cash collateral.

Under the provisions of state statutes, the BOI has, by a Securities Lending Authorization Agreement, authorized the custodial bank, State Street Bank (SSB), to lend the BOI's securities to broker-dealers and other entities with a simultaneous agreement to return the collateral for the same securities in the future. During the period the securities are on loan, the BOI receives a fee and the custodial bank must initially receive collateral equal to 102% of the fair value of the securities on loan and must maintain collateral equal to not less than 100% of the fair value of the loaned security. The BOI retains all rights and risks of ownership during the loan period.

The cash collateral received on each loan was invested, together with the cash collateral of other qualified plan lenders, in a collective investment pool, the Securities Lending Quality trust. The relationship between the average maturities of the investment pool and the BOI's loans was affected by the maturities of the loans made by other plan entities that invested cash collateral in the collective investment pool, which the BOI could not determine. On June 30, 2004 and June 30, 2003, the BOI had no credit risk exposure to borrowers.

The following table presents the carrying and market values of the securities on loan and the total collateral held for fiscal years ended June 30, 2004 and June 30,2003 for both MSF and the Old Fund:

	MSF		Old Fund	
	Fiscal Year 2004	Fiscal Year 2003	Fiscal Year 2004	Fiscal Year 2003
Securities on Loan-Book Value	$134,808,112	$26,912,989	$14,099,489	$5,511,175
Securities on Loan-Market Value	$137,258,780	$30,180,923	$14,210,615	$5,971,982
Total Collateral Held	$141,060,425	$30,968,721	$13,248,863	$6,099,450

As of June 30, 2004, MSF and the Old Fund investments include $134.8M and $14.0M respectively, in long-term securities on loan that earned interest income during the fiscal year of $939K and $119K respectively.

As of June 30, 2003, MSF and the Old Fund investments include $26.9M and $5.5M respectively, in long-term securities on loan that earned interest income during the fiscal year of $751K and $187K respectively.

In November 2000, the Montana Constitution was amended to allow investing in equity securities, with the restriction that equity securities cannot exceed 25% of total investment book value.

However, in May 2003, the BOI approved a policy statement to keep equities in the 8% to 12% range. As of June 30, 2004, equity securities in MSF include $68.4M at book value, enhanced by $3.7M in market value appreciation. As of June 30, 2003, equity securities in MSF include $79.M at book value, offset by $9.0M in market value depreciation.

Additional investment information can be found in Note 2.

Receivables

MSF's premium receivable balance is $5.8M at June 30, 2004 , which is then reduced by estimated uncollectible receivables reported as an allowance for doubtful accounts of $598Kleaving a net receivable balance of $5.2M. Other receivables include $7.5M in investment income due and $142K in notes and loans receivable, of which $37K is long term.

MSF's premium receivable balance is $4.6M at June 30, 2003, which is then reduced by estimated uncollectible receivables reported as an allowance for doubtful accounts of $469K leaving a net receivable of $4.1M. Other receivables include $6.6M in investment income due and $199K in notes and loans receivable, of which $73K is long term.

Accounts receivable in the Old Fund include amounts due from past premiums in dispute or in collection and amounts due from Old Fund Liability Tax collections. Net accounts receivable for year ended June 30, 2004 and June 30, 2003 were $64K and $98K, respectively. Estimated uncollectible receivables are reported as an allowance for doubtful accounts. Interest receivable of $1.0M at June 30, 2004 and $1.2M at June 30, 2003 represents investment income due.

Equipment and Accumulated Depreciation

Equipment is capitalized if the actual or estimated historical cost exceeds $5K. Depreciation expense is computed on a straight-line basis for equipment over a period of three to five years and amortization of intangible assets is computed on a straight-line basis over five years. Amortization of intangible assets is applied directly to the asset balance. All fixed assets are recorded in the MSF. Because MSF administers the Old Fund, the Old Fund does not carry fixed assets.

Other Assets

Other assets include security deposits received from certain policyholders. The deposits secure payment of premiums. Also included are deferred acquisition costs incurred during the policy writing process and that are recognized ratably over the related policy term.

Estimated Claims Payable

The estimated claims payable is established to provide for the estimated ultimate settlement cost of all claims incurred. Estimated claims payable is based on reported aggregate claim cost estimates combined with estimates for future development of such claim costs and estimates of incurred but not reported (IBNR) claims. Tillinghast-Towers Perrin, an external actuarial firm, prepares an actuarial study that provides a range of potential cost associated with reported claims, the future development of those claims and IBNR. MSF management has selected the best estimates within that range as the estimated claims payable for both MSF and Old Fund. For additional disclosure related to the estimated claims payable, refer to Note 4.

Deferred Revenue

Deferred revenue reflects amounts received or billed in advance, but not yet earned for policies effective July 1, 2004 or July 1, 2003.

Property Held in Trust

Property Held in Trust consists of security deposits owed to certain policyholders and the reinsurance funds withheld account, a requirement of MSF's aggregate stop loss reinsurance contract. Additional information regarding the funds withheld account can be found in Note 3.

Net Assets

Net assets consist of the net excess or deficit of assets over liabilities. For additional information on distributions impacting total net assets see Note 6.

Premiums

The MSF Board of Directors approves premium rates annually. Generally, policies are effective for the term of the policy period not to exceed 12 months. Premium revenue is recognized over the term of the fiscal year, which runs from July 1 through June 30, as it is earned or when MSF is liable for coverage.

Policyholders are contractually obligated to pay certain premiums to MSF in advance of the period the premiums are earned. Premium advances are refundable when the policyholder's coverage is canceled and all earned premiums have been credited by MSF.

Presentation

The financial statements are presented in accordance with generally accepted accounting principles as prescribed by the Governmental Accounting Standards Board. MSF insurance operations are classified as an enterprise fund, proprietary fund type. MSF comprises only a part of the State of Montana's enterprise funds. The financial statements in this report reflect the financial position and results of operations and cash flows of MSF and Old Fund, not the State of Montana.

An enterprise fund is used to account for operations: (a) financed and operated in a manner similar to private business enterprises, where the legislature intends that the entity finance or recover costs primarily through user charges; (b) where the legislature has decided that periodic determination of revenues earned, expenses incurred or net income is appropriate; (c) where the activity is financed solely by a pledge of the net revenues from fees and charges of the activity; (d) when laws or regulations require that the activities' costs of providing services be recovered with fees and charges rather than with taxes or similar revenues.

Investments are presented in accordance to GASB Statement Number 31, "Accounting and Financial Reporting for Certain Investments and External Investment Pools." STIP is considered an external investment pool, which is defined as an arrangement that pools the monies of more than one legally separate entity and invests, on the participant's behalf, in an investment portfolio. STIP is also classified as a "2a7-like" pool. A 2a7-like pool is an external investment pool that is not registered with the Securities and Exchange Commission (SEC) as an investment company, but has a policy that it will, and does, operate in a manner consistent with the SEC's Rule 2a7 of the Investment Company Act of 1940. If certain conditions are met, 2a7-like pools are allowed to use amortized cost rather than fair value to report net assets to compute unit values. The BOI has adopted a policy to treat STIP as a 2a7-like pool. See Note 1, Basis of Accounting – Investments and Note 2 for further discussions of the effect of GASB 31.

2. Investments

The amortized cost and market value of MSF's fixed maturity securities as of June 30, 2004, and June 30, 2003, are as follows:

		Gross Unrealized		
June 30, 2004	Amortized Cost	Gain	Loss	Market Value
Government Direct-Indirect	$ 182,136,355	$ 5,413,826	$ 2,591,072	$ 184,959,109
Government Mortgage-Backed	43,220,924	1,049,286	314,329	43,955,881
Corporate Securities Asset-Backed	23,105,996	-	247,250	22,858,746
Other Corporate Securities	242,107,218	8,690,647	2,349,713	248,448,152
Other Securities	8,940,976	766,385	-	9,707,361
Equity Securities	68,406,676	3,731,698	-	72,138,374
STIP (reported as Cash & Cash Equivalents)	18,207,649	-	-	18,207,649
Total	$ 586,125,794	$ 19,651,842	$ 5,502,364	$ 600,275,272

		Gross Unrealized		
June 30, 2003	Amortized Cost	Gain	Loss	Market Value
Government Direct-Indirect	$ 151,604,707	$ 13,548,818	$ -	$ 165,153,525
Government Mortgage-Backed	68,051,580	2,730,889	11,093	70,771,376
Corporate Securities Asset-Backed	15,494,410	520,577	-	16,014,987
Other Corporate Securities	186,427,682	17,125,494	720,462	202,832,714
Other Securities	15,960,381	1,632,258	-	17,592,639
Equity Securities	79,000,000	-	9,041,847	69,958,153
STIP (reported as Cash & Cash Equivalents)	29,965,376	-	-	29,965,376
Total	$ 546,504,136	$ 35,558,036	$ 9,773,402	$ 572,288,770

The amortized cost and estimated market value of MSF's fixed maturity securities as of June 30, 2004 and June 30, 2003, are shown below at contractual maturity. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

June 30, 2004

	Amortized Cost	Market Value
Due one year or less	$ 44,573,096	$ 45,051,831
Due after one year through five years	147,503,678	152,273,132
Due after five years through ten years	230,617,869	234,268,425
Due after ten years	95,024,475	96,543,510
Equity Securities	68,406,676	72,138,374
Total	$ 586,125,794	$ 600,275,272

June 30, 2003

	Amortized Cost	Market Value
Due one year or less	$ 39,654,290	$ 39,841,311
Due after one year through five years	134,969,918	148,798,953
Due after five years through ten years	175,587,858	191,300,916
Due after ten years	117,292,070	122,389,437
Equity Securities	79,000,000	69,958,153
Total	$ 546,504,136	$ 572,288,770

During fiscal year ending June 30, 2004, MSF realized gross gains from sales of securities of $1.8M and gross realized losses of $742K. During fiscal year ending June 30, 2003, MSF realized gross gains from sales of securities of $3.1M and gross realized losses of $987K.

As discussed in Note 1, GASB 31 requires governmental entities to report their investments at fair value. Fair value is defined as the amount at which an investment could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale. The adjustment to fair value is reflected as an increase or decrease in investment income. During fiscal year 2004, investment income for MSF was adjusted downward $11.6M due to the unrealized loss on long-term investments. Investment income for fiscal year 2003 was adjusted upward $19.3M for the unrealized gain that occurred during that year on long-term investments.

Montana State Fund
(A Component Unit of the State of Montana)
Notes to Financial Statements
June 30, 2004 and 2003

The amortized cost and market value of the Old Fund fixed maturity securities as of June 30, 2004 and June 30, 2003 are as follows:

		Gross Unrealized		
June 30, 2004	Amortized Cost	Gain	Loss	Market Value
Government Direct-Indirect	$ 41,297,467	$ 1,313,283	$ 163,235	$42,447,515
Government Mortgage-Backed	7,825,891	144,119	127,795	7,842,215
Corporate Securities Asset-Backed	4,924,938	-	142,178	4,782,760
Other Corporate Securities	13,605,022	538,082	-	14,143,104
Other Securities	-	-	-	-
STIP (reported as Cash & Cash Equivalents)	3,682,851	-	-	3,682,851
Total	$ 71,336,169	$ 1,995,484	$ 433,208	$ 72,898,445

		Gross Unrealized		
June 30, 2003	Amortized Cost	Gain	Loss	Market Value
Government Direct-Indirect	$ 40,202,202	$ 3,509,668	$ -	$ 43,711,870
Government Mortgage-Backed	11,699,352	335,849	5,547	12,029,654
Corporate Securities Asset-Backed	12,105	4	-	12,109
Other Corporate Securities	21,610,457	1,527,019	-	23,137,476
Other Securities	2,999,057	12,193	-	3,011,250
STIP (reported as Cash & Cash Equivalents)	4,738,975	-	-	4,738,975
Total	$ 81,262,148	$ 5,384,733	$ 5,547	$ 86,641,334

The amortized cost and market value of the Old Fund fixed maturity securities as of June 30, 2004 and June 30, 2003 are shown below at contractual maturity. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

June 30, 2004

	Amortized Cost	**Market Value**
Due one year or less	$ 8,687,550	$ 8,778,135
Due after one year through five years	31,463,278	32,213,607
Due after five years through ten years	21,930,972	22,922,307
Due after ten years	9,254,369	8,984,396
Total	$ 71,336,169	$ 72,898,445

June 30, 2003

	Amortized Cost	Market Value
Due one year or less	$ 13,739,199	$ 13,889,831
Due after one year through five years	34,232,457	37,129,943
Due after five years through ten years	25,527,198	27,511,378
Due after ten years	7,763,294	8,110,182
Total	$ 81,262,148	$ 86,641,334

During the fiscal year ended June 30, 2004, the Old Fund realized $336K gross gains from sales of securities. During the fiscal year ended June 30, 2003, the Old Fund realized $633K in gross gains from sales of securities and $48K in gross realized losses.

During fiscal year 2004, the effect of GASB 31 on Old Fund investment income was a decrease of $3.8M due to unrealized losses on its long-term portfolio. The effect of GASB 31 on Old Fund investment income for fiscal year 2003 was an increase of $3.4M due to unrealized gains on its long-term portfolio.

3. Reinsurance

For the fiscal years ended June 30, 2004 and June 30, 2003, MSF ceded reinsurance to other reinsurance companies to limit the exposure arising from large losses. These arrangements consist of excess of loss contracts that protect against occurrences over stipulated amounts and an aggregate stop loss contract. The excess of loss contracts provide coverage of $95.0M for both fiscal years 2004 and 2003. During fiscal years 2004 and 2003, MSF retained the first $5.0M for the first layer of reinsurance coverage. Individual, per person coverage was provided up to $5.0M per any one individual loss for both fiscal years 2004 and 2003.

The term of the current aggregate stop loss contract is July 1, 2002 through June 30, 2005. The contract provides coverage based on MSF's premium levels at $8.6M per year but not to exceed $21.0M in the aggregate over three years. In the event reinsurers are unable to meet their obligations under either the excess of loss contracts or aggregate stop loss contract, MSF would remain liable for all losses, as the reinsurance agreements do not discharge MSF from its primary liability to the policyholders.

Premium revenue is reduced by premiums paid for reinsurance coverage of $6.6M and $5.7M in fiscal years 2004 and 2003, respectively. The aggregate stop loss contract requires that MSF maintain a funds withheld account which represents the basic premium portion of the total premium paid for aggregate stop loss coverage. The total funds withheld account at June 30, 2004 is $4.8M comprised of $2.6M of basic premium for fiscal year 2004 and $2.2M for fiscal year 2003. Interest must be accrued quarterly at an annual rate of 6.5% on the funds withheld account, resulting in accrued interest of $326K for fiscal year 2004 and $143K for fiscal year 2003.

During fiscal years 2004 and 2003, estimated claim reserves were reduced $10.0M and $8.0M respectively, for the amount of reinsurance estimated to be ultimately recoverable on incurred losses.

MSF also has assumed reinsurance relationships with Argonaut Insurance Company, Fireman's Fund Insurance Company and Legion Insurance Company related to Other States Coverage (OSC). MSF assumes risk for OSC claims, which are then covered under MSF's ceded reinsurance contract. Assumed premium for fiscal years 2004 and 2003 is $2.0M and $1.6M, respectively. The assumed liability for OSC claims is $1.5M for fiscal year 2004 and $2.3M for fiscal year 2003.

4. Risk Management

MSF provides liability coverage to employers for injured employees that are insured under the Workers' Compensation and Occupational Disease Acts of Montana. Workers' compensation claims occurring on or after July 1, 1990, are reported in the MSF. At June 30, 2004, approximately 26,963 active policies were insured by MSF. At June 30, 2003, approximately 25,977 active policies were insured by MSF.

MSF is a self-supporting, competitive state fund and functions as the insurer of last resort. Workers' compensation insurance is mandatory in Montana. Employers may obtain coverage through private carriers, through MSF or through self-insurance if they meet certain criteria. Public entities may self-insure or insure through MSF.

MSF serves as claim administrator on claims for injuries that occurred before July 1, 1990, known as the Old Fund. The Old Fund is considered a debt of the State of Montana and not MSF. Neither MSF or the Old Fund had significant reductions in insurance coverage from the prior year, nor any insurance settlements exceeding insurance coverage. Unpaid claims and claims adjustment expenses are estimated based on the ultimate cost of settling the claims including the effects of inflation and other social and economic factors. When MSF purchases annuity contracts, the claim is settled in full and on a final basis, and all liability of MSF is terminated.

Tillinghast-Towers Perrin, an external actuarial firm, prepares an actuarial study used to estimate liabilities and the ultimate cost of settling claims reported but not settled and claims incurred but not reported (IBNR) for MSF as of June 30, 2004 and June 30, 2003. Because actual claim costs depend on such complex factors as inflation and changes in the law, claim liabilities are recomputed periodically using a variety of actuarial and statistical techniques to produce current estimates that reflect recent settlements, claim frequency, and other economic and social factors. A provision for inflation is implicit in the calculation of estimated future claim costs because reliance is placed both on actual historical data that reflects past inflation and on other factors that are considered to be appropriate modifiers of past experience.

Tillinghast-Towers Perrin provides a range of potential costs associated with reported claims, the future development of those claims and IBNR. MSF management has selected the best estimate within that range as the estimated claims payable, consisting of unpaid claims and claim adjustment expenses, for fiscal years 2004 and 2003. The MSF estimated claims payable is presented at face value, net of estimated reinsurance recoverable, at $452.1M and $413.4M, as of June 30, 2004 and June 30, 2003, respectively. The estimated claims payable increased $38.7M from 2003 to 2004 primarily due to reserve strengthening of approximately $19.9M on prior year claims. MSF currently has no knowledge of any significant environmental or asbestos claims that would contribute to this estimate.

State law requires MSF to set premiums at least annually at a level sufficient to ensure adequate funding of the insurance program during the period the rates will be in effect. Anticipated investment income is considered when computing premium rate levels. State law also requires the MSF Board of Directors to establish surplus above risk based capital requirements to secure MSF against risks inherent in the business of insurance.

Acquisition costs represent costs associated with the acquisition of new insurance contracts or renewal of existing contracts and include agent commissions and expenses incurred in the underwriting process. MSF acquisition costs are capitalized and amortized ratably over the subsequent year. Capitalized acquisition costs at June 30, 2004 and June 30, 2003 are $1.0M and $1.5M respectively. For the years ended June 30, 2004 and June 30, 2003, acquisition costs that were amortized are $1.5M and $878K respectively.

The Old Fund covers the liability and payment of workers' compensation claims for incidents occurring before July 1, 1990. Funding for claims payments was provided by Old Fund Liability Taxes (OFLT) which are no longer in effect. The only OFLT activity that remains is miscellaneous collections and adjustments. Old Fund investment earnings must fund future claims payments.

An actuarial study prepared by Tillinghast-Towers Perrin for the Old Fund as of June 30, 2004 and June 30, 2003, is used to estimate liabilities and the ultimate cost of settling claims that have been reported, but not settled and claims that have been incurred, but not reported (IBNR). Tillinghast-Towers Perrin provides a range of potential cost associated with reported claims, the future development of those claims and IBNR. MSF management has selected the best estimate within that range as the estimated claims payable, consisting of unpaid claims and claim adjustment expenses, for fiscal years 2004 and 2003. As of June 30, 2004, the undiscounted estimated claims payable is $108.5M and is presented at net present value of $80.8M discounted at a 5.25% rate. As of June 30, 2003, the undiscounted estimated claims payable is $113.1M and is presented at net present value of $80.9M discounted at a 5.25% rate.

Changes in Claims Liabilities for the Past Two Years

The following table presents changes in the aggregate liabilities for MSF and the Old Fund for the past two years net of estimated reinsurance recoverable. The information presented has not been discounted.

	MSF	
	2004	2003
Unpaid claims and claim adjustment expenses at beginning of year	$ 413,400,000	$ 346,400,000
Incurred claims and claim adjustment expenses:		
Provision for insured events of the current year	136,058,828	116,597,841
Increase (decrease) in provision for events of prior years	13,568,639	35,366,198
Total incurred claims and claim adjustment expenses	149,627,467	151,964,039
Payments:		
Claims and claim adjustment expenses attributable to insured events of the current year	(34,574,875)	(22,981,961)
Claims and claim adjustment expenses attributable to insured events of prior years	(76,337,592)	(61,982,078)
Total Payment	(110,912,467)	(84,964,039)
Total unpaid claims and claim adjustment expenses at end of year	$ 452,115,000	$ 413,400,000

	Old Fund	
	2004	2003
Unpaid claims and claim adjustment expenses at beginning of year	$ 113,180,563	$ 128,902,238
Incurred claims and claim adjustment expenses:		
Provision for insured events of the current year	-	-
Increase (decrease) in provision for events of prior years	8,215,581	(1,448,292)
Total incurred claims and claim adjustment expenses	8,215,581	(1,448,292)
Payments:		
Claims and claim adjustment expenses attributable to insured events of the current year	-	-
Claims and claim adjustment expenses attributable to insured events of prior years	(12,896,209)	(14,273,383)
Total Payment	(12,896,209)	(14,273,383)
Total unpaid claims and claim adjustment expenses at end of year	$ 108,499,935	$ 113,180,563

Risk Management Trend Information

The following table illustrates how the earned revenues of MSF plus investment income compare to related costs of loss and other expenses assumed by MSF for fiscal years 1995 through 2004. In addition, cumulative amounts related to estimated and actual paid claims are presented. The information allows for comparison of actual and estimated claims and is a basis for developing revenue and claims information. As data for individual policy years mature, the correlation between original estimates and re-estimated amounts is used to evaluate the accuracy of incurred claims currently recognized for less mature policy years.

Montana State Fund
(A Component Unit of the State of Montana)
Notes to Financial Statements
June 30, 2004 and 2003

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
1. Premiums and Investment Revenue										
Earned	193,096	136,939	104,260	89,522	81,215	89,885	114,225	127,292	161,713	121,494
Ceded	269	519	348	303	260	855	2,952	(465)	5,654	6,563
Net Earned	192,827	136,418	103,912	89,219	80,955	89,030	111,273	127,757	156,059	114,931
2. Unallocated expenses including overhead	14,463	17,554	12,736	14,525	19,136	22,306	27,035	29,844	33,842	42,088
3. Estimated losses and expenses, end of accident year										
Incurred	164,628	95,067	76,067	64,983	64,645	65,957	68,267	81,560	110,153	120,705
Ceded	-	-	-	-	-	-	-	-	-	-
Net Incurred	164,628	95,067	76,067	64,983	64,645	65,957	68,267	81,560	110,153	120,705
4. Net paid (cumulative) as of:										
End of policy year	18,137	15,818	12,589	12,943	13,723	13,177	14,140	16,693	22,982	26,123
One year later	40,473	32,890	28,451	28,222	29,976	29,218	32,888	38,185	48,861	
Two years later	52,073	42,361	35,706	35,753	39,298	37,555	45,218	52,359	-	
Three years later	58,722	47,283	39,860	41,004	45,748	43,649	55,248	-	-	
Four years later	62,419	50,267	43,105	44,478	49,984	48,322	-	-	-	
Five years later	65,919	52,791	46,478	47,584	54,212	-	-	-	-	
Six years later	68,541	54,962	48,505	50,188	-	-	-	-	-	
Seven years later	70,816	57,654	50,402	-	-	-	-	-	-	
Eight years later	72,803	59,193	-	-	-	-	-	-	-	
Nine years later	74,989	-	-	-	-	-	-	-	-	
5. Re-estimated ceded losses and expenses	-	-	6,477	582	2,311	-	-	-	-	
6. Re-Estimated net incurred losses and expense:										
End of policy year	164,628	95,067	76,067	64,983	64,645	65,957	68,267	81,560	110,153	120,705
One year later	124,123	88,923	67,235	64,308	64,348	66,421	71,094	86,799	110,532	
Two years later	107,074	77,286	59,054	60,467	66,660	66,662	81,053	91,241	-	
Three years later	95,456	73,864	60,811	61,989	69,345	70,302	88,157	-	-	
Four years later	94,517	74,022	64,439	64,944	72,435	72,492	-	-	-	
Five years later	92,231	73,197	59,079	67,312	73,710	-	-	-	-	
Six years later	91,771	74,329	60,528	67,772	-	-	-	-	-	
Seven years later	92,637	76,955	60,630	-	-	-	-	-	-	
Eight years later	93,637	76,849	-	-	-	-	-	-	-	
Nine years later	94,036	-	-	-	-	-	-	-	-	
7. Increase (decrease) in estimated net incurred losses and expenses from end of policy year	(70,592)	(18,218)	(15,437)	2,789	9,065	6,535	19,890	9,681	379	0

(All dollars are expressed in 000's.)

5. Administrative Cost Allocation

State law (Section 39-71-2352, MCA) requires MSF to separately determine and account for administrative expenses and benefit payments for claims for injuries resulting from accidents occurring before July 1, 1990 (Old Fund) from those occurring on or after July 1, 1990 (MSF). The law also limits annual administrative costs of claims associated with the Old Fund to $1.25M. MSF allocated $1.25M in administration costs to the Old Fund in each of fiscal years 2004 and 2003. The Old Fund has a $1.0M obligation to MSF in unrecovered administrative costs incurred in fiscal years 2004 and prior. MSF intends to recover this amount in future years where the cost of administering the Old Fund is less than the statutorily permitted $1.25M.

6. MSF Distributions

Dividends Paid to Policyholders

During the fiscal years ended June 30, 2004 and June 30, 2003, the MSF Board of Directors authorized and paid dividends to policyholders for $1.9M for policy year 2002 and $2.9M for policy year 2001, respectively.

Payments from Old Fund to MSF and State of Montana

House Bill Number 363 (HB 363), enacted by the 2003 Montana Legislature, changes existing law regulating the Old Fund transfer of surplus. HB 363 removed the 10% contingency reserve requirement for the Old Fund and transfers the reserve as well as any remaining available funds from Old Fund to the State of Montana General Fund.

The transfer amount to the General Fund in fiscal year 2004 is $816K and for 2003 is $22.2M. Refer to Note 7 for additional information regarding HB 363.

7. Old Fund Net Asset Position

As of December 31, 1998, the Old Fund Liability Tax was terminated and a process was put in place to measure the status of the Old Fund's surplus level annually on a present value basis using a discount factor of 5.25% to determine compliance with state law requirements for maintaining fund adequacy.

Section 39-71-2352 (5), MCA, provided for the payment of excess funds from the Old Fund to the State of Montana General Fund based on adequate funding levels in the Old Fund. This law defined the term "adequately funded" to mean the present value of:

a) the total cost of future benefits remaining to be paid; and,
b) the cost of administering the claims; and,
c) adjusted for any unrealized gains and losses.

As stated in Note 6, HB 363, enacted by the 2003 Montana Legislature, changed the law regulating the Old Fund transfer of surplus. HB 363 allows the transfer of any amounts above the amount of "adequately funded" to the State of Montana General Fund. In addition, future excess funds will continue to be transferred to the General Fund.

As a result of HB 363, the calculation of excess funds to be transferred increased to \$22.2M as of June 30, 2003. These funds were transferred to the General Fund. The funds transferred to the General Fund as of June 30, 2004 are \$815K. In order to value liabilities consistently with investments, the estimated claims liability discount rate is 5.25% in 2003 and 2004. The Old Fund net asset level using a present value discount factor of 5.25% is \$(7.4M) as of June 30, 2004 and \$6.2M as of June 30, 2003. The negative fund balance for June 30, 2004 is the direct result of the transfers made from the Old Fund to the General Fund mandated by HB 363 and an increase in the estimated claims payable as a result of increased medical cost trends. This does not indicate that the Old Fund does not have adequate financial resources to satisfy current claims obligations. Applying the current actuarially estimated payout pattern of the Old Fund there is sufficient invested assets to meet its obligations until the year 2014. At that time current law would require the General Fund to satisfy all outstanding claims when the Old Fund has liquidated all financial resources and cannot meet its obligations.

8. Compensated Absences

MSF supports two leave programs, the State of Montana Leave Program and the MSF Personal Leave Program, implemented in January 2002. The State of Montana Leave Program covers all union represented employees. Union represented employees accumulate both annual leave and sick leave and MSF pays employees 100% of unused annual leave and 25% of unused sick leave upon termination. MSF also pays 100% of unused compensatory leave credits upon termination to nonexempt employees. MSF Personal Leave Program covers all non-union employees. Non-union employees accumulate personal leave and extended leave. MSF pays employees for 100% of unused personal leave upon termination but extended leave has no cash value at the time of termination.

MSF absorbs expenditures for termination pay in its annual operational costs. MSF may allocate some of these costs to Old Fund as a portion of the Old Fund administrative cost allocation. The total leave liability for MSF and Old Fund is \$1.7M and \$0, respectively, for fiscal year 2004. The total leave liability for MSF and Old Fund is \$1.4M and \$63K, respectively for fiscal year 2003.

9. Retirement Plans

MSF and its employees contribute to the Public Employees Retirement System (PERS), which offers two types of retirement plans administered by the Public Employees' Retirement Board (PERB). The first plan is the Defined Benefit Retirement Plan (DBRP), a multiple-employer, cost-sharing plan that provides retirement, disability and death benefits to plan members and their beneficiaries. Benefits are based on eligibility, years of service and highest average compensation. Vesting occurs once membership service totals five years. Benefits are established by state law and can only be amended by the legislature.

The second plan is the Defined Contribution Retirement Plan (DCRP), created by the 1999 legislature and available to all active PERS members effective July 1, 2002. This plan is a multiple-employer, cost-sharing plan that also provides retirement, disability and death benefits to plan members and their beneficiaries. Benefits are based on the balance in the member's account, which includes the total contributions made, the length of time the funds have remained in the plan, the investment earnings less administrative costs.

Eligible PERS members choose to participate in either the DBRP or DCRP but may not be active members of both plans. MSF and its employees are required to contribute 6.9% of annual compensation in fiscal years 2004 and 2003. MSF's contributions amounted to $830K for fiscal year 2004 and $710K for fiscal year 2003. MSF and its employees paid one hundred percent of required contributions to PERS and there is no unpaid liability as of June 30, 2004.

The PERS financial information is reported in the Public Employees' Retirement Board *Comprehensive Annual Financial Report* for the fiscal year-end. It is available from PERB at 100 North Park Avenue, Suite 220, P. O. Box 200131, Helena, MT 59620-0131, 406 444-3154.

MSF and its employees are eligible to participate in the State of Montana Deferred Compensation Plan (457 plan) administered by the PERB. The Deferred Compensation plan is a voluntary, tax-deferred retirement plan designed as a supplement to other retirement plans. Under the plan, eligible employees elect to defer a portion of their salary until future time periods. MSF incurs no costs for this plan.

10. Building

The 1981 Legislature appropriated funds for the construction of a workers' compensation building. As of July 1, 1990, MSF transferred the value of the building from its records to the Department of Administration, which owns most other state buildings and charges agencies rent for their use. Under an agreement, which expires on July 31, 2005, MSF pays all costs associated with the building, including utilities, property taxes, janitorial services, and maintenance in lieu of paying rent.

11. Contingencies

Murer, et al v. Montana State Compensation Mutual Insurance Fund, et al., WCC No. 9206-6487, involves the 1987 legislature's capping of workers' compensation benefits ($299.00 a week for total benefits and $149.50 a week for partial benefits) for injuries occurring during the period July 1, 1987 through June 30, 1989. The 1989 legislature reenacted those caps for the period July 1, 1989 through June 30, 1991 for injuries occurring between July 1, 1989 and June 30, 1991.

The Montana Supreme Court found that these caps should have expired on June 30, 1989 for injuries occurring between July 1, 1987 and June 30, 1989 and should have expired on June 30, 1991 for injuries occurring between July 1, 1989 and June 30, 1991.

As a result, the Montana State Fund, under Workers' Compensation Court direction, performed a review of approximately 7500 claims. Those claims qualifying are paid 85% of the increased rate, with 15% paid to the claimant attorney. Cost impact is estimated to be over $1 million but with a cost no greater than $2 million. The cost impact has been paid or is included in Montana State Fund's loss reserves. The review and payment process is near finalization, but ongoing.

State Compensation Insurance Fund v. George Berg, et al., Case No. DV-99-34 (Fergus County), is a pending suit against a former policyholder in which the Montana State Fund claims the policyholder failed to pay workers' compensation insurance premiums, plus interest on the unpaid premiums. The total claim was originally for $1,045,954.49, but on further evaluation has been reduced to approximately $660,000. Berg filed a counterclaim against the Montana State Fund on various claims, seeking unspecified damages. Montana State Fund does not think the counterclaim has merit, but there is a remote chance of an adverse judgment against the Montana State Fund. This matter was expected to go to trial sometime during 2001. However, Berg filed a Chapter 11 bankruptcy petition in Montana Bankruptcy Court, which stayed any further proceedings in the state court action. The Montana State Fund entered into a tentative settlement with Berg for payment of $100,000 cash, plus $125,000 payable over time. This settlement was subject to approval by the bankruptcy court in a Chapter 11 plan of reorganization. However, the bankruptcy court converted the case to a Chapter 7 liquidation. This had the effect of resurrecting the Montana State Fund's original claim amount of $660,000. The bankruptcy trustee is now liquidating Berg's bankruptcy estate. At this time, Montana State Fund is not certain how much of this claim will be recovered.

Stavenjord v. State Compensation Insurance Fund. The Workers Compensation Court decided that the Stavenjord case should be applied retroactively but only to June 3, 1999. The court also held that a common fund does exist and that the claimant is entitled to common fund attorney fees with respect post-June 3, 1999 Stavenjord entitlements. The impact of the decision is determined to be $2,150,000 and is reflected in the fiscal year 2004 Statement of Revenues, Expenses, and Changes in Net Assets. This decision has been appealed to the Montana State Supreme Court. The Stavenjord case was issued by the Workers' Compensation Court on May 22, 2001. It addressed the issue of whether the failure of the Occupational Disease Act (ODA) to provide PPD (permanent partial disability) benefits equivalent to the benefits provided in the Montana WCA (workers' compensation act) violates the claimant's right to equal protection of the law. Relying on the Henry case (previous case from the Supreme Court finding that vocational rehabilitation benefits must also be paid under the ODA), the court said it did, holding "Where PPD benefits calculated pursuant to the WCA are greater that the benefits available to a claimant under the ODA, constitutional equal protection guarantees require that benefits be computed and paid in accordance with the WCA. The claimant in this case is entitled to $27,027 under the WCA, versus $10,000 under the ODA." The case was affirmed by the Montana Supreme Court on April 1, 2003.

Robert Flynn v. State Compensation Insurance Fund. The Claimant, Robert Flynn, filed a petition in the Workers' Compensation Court for the State of Montana in which he alleged that the Respondent, State Compensation Insurance Fund, should pay a proportionate share of the attorney fees he incurred to recover social security disability benefits. Flynn also requested that the Court sanction the Montana State Fund for unreasonably reducing his temporary total disability benefits in an effort to recoup overpayments. The Workers' Compensation Court denied both of Flynn's claims and Flynn appealed. The Court affirmed in part and reversed in part the judgment of the Workers' Compensation Court. (1) The Court decided that pursuant to the common fund doctrine, the Montana State Fund should contribute, in proportion to the benefits it actually received, to the costs of the litigation, including reasonable attorney fees. The Workers' Compensation Court erred when it denied Flynn's request for reasonable apportionment of attorney fees. To the extent it declined to apply the common fund doctrine, the judgment of the Workers' Compensation Court was reversed by the Supreme Court. (2) The Supreme Court agreed that nothing in the record indicated that the Montana State Fund acted unreasonably in offsetting Flynn's benefits. Therefore, the Workers' Compensation Court did not err when it concluded that the Montana State Fund was entitled to reduce Flynn's disbursements to the extent that it did to recover overpaid benefits. The matter is currently on remand, and the Workers' Compensation Court ruled on August 5, 2003 on the issues of whether a common fund had been established and whether the decision should be applied retroactively. The court ruled for the claimant on both issues as follows, " Since claimant's entitlement to attorney fees is a matter of law and arose only after the decision on appeal, the post-remand request for attorney fees is timely." Also, "Whether the blanket rule of retroactivity of judicial decisions adopted by the United States Supreme Court in Harper v. Virginia Dept. of Taxation, 509 U.S. 86 (1993), or the more flexible rule from Chevron Oil C. v. Huson, 404 U.S. 97 (1971), is applied, the decision in Flynn v. State Compensation Ins. Fund, 2002 MT 279, 312 Mont. 410, 60 P.3d 397, must be applied retroactively." A settlement agreement was reached. The parties are in the process of implementing the settlement agreement. The estimated cost to settle of $375,000 is reflected in the financial statements.

Schmill v. Liberty Northwest Insurance, 2003 MT 80, decided April 10, 2003 by the Montana Supreme Court held as follows, "We conclude that the ODA and the WCA treat similarly situated classes of workers differently. Furthermore, apportioning Schmill's permanent impairment award for her occupational disease pursuant to § 39-72-706, MCA, of the ODA while providing full benefits for injured workers pursuant to the WCA is not rationally related to a legitimate governmental interest. Therefore, we conclude that § 39-72-706, MCA, violates the equal protection guarantee found at Article II, Section 4 of the Montana Constitution. The judgment of the Workers' Compensation Court is affirmed." Retroactive application of the decision and its status as a common fund is presently before the Workers' Compensation Court in on-going litigation. The decision of the Workers' Compensation Court will likely be appealed to the Montana Supreme Court by at least one of the parties. Should the ultimate decision of the Montana Supreme Court be to create a common fund and apply the decision retroactively, the cost is estimated at $1.5 to $2 million dollars. Should the ultimate decision of the Montana Supreme Court be to apply the decision retroactively, the impact on the Old Fund liability for claims that occurred before July 1, 1990 is estimated at $800,000. Final disposition is unknown at this time. This was not a case against the Montana State Fund, but the holding of this decision applies to Montana State Fund. Montana State Fund's motion to intervene in the case was granted by the Workers' Compensation Court. In addition a separate case against the Montana State Fund on this same issue has been filed in the Workers' Compensation Court against Montana State Fund, *Minnick.*

Wild v. Fregein and Montana State Compensation Insurance Fund, 2003 MT 115, decided April 29, 2003, primarily held that § 39-71-401(3), MCA, does not, as a matter of law, conclusively preclude any factual inquiry into whether an employer/employee relationship exists once the worker has been issued the exemption contemplated by § 39-71-401(3), MCA.", and .... "that § 39-71-401(3), MCA, read in conjunction with § 39-71-120, MCA, does require the employer to make an initial good faith inquiry of the worker to determine that he or she does, in fact, meet the control and independently established business tests before the employer employs the worker as an IC and if the employer determines the worker is an IC, to thereafter treat the worker as an IC and not as an employee as Fregein treated Wild in this case." Retroactive application of the decision and its status as a common fund is presently before the Workers' Compensation Court in on-going litigation. As data on identification of potential claims is difficult to identify, no analysis of cost estimates on retroactive application of the decision is available at this time.

MONTANA STATE FUND

5 South Last Chance Gulch • P.O. Box 4759 • Helena, MT 59604-4759
Customer Service: 1-800-332-6102 or 406-444-6500
Fraud Hotline: 1-888-682-7463 (888-MT-CRIME)

November 29, 2004

RECEIVED
DEC 01 2004
LEGISLATIVE AUDIT DIV.

Mr. Scott A. Seacat
Legislative Audit Division
Room 160, State Capitol
Helena, MT 59620-1705

Dear Mr. Seacat:

Montana State Fund (MSF) appreciates the efficient and professional approach of the audit staff involved in this review of our governmental financial statements. Once again, we are pleased with your issuance of an unqualified opinion without any audit recommendations on the financial statements we have presented.

We understand how maintaining a strong financial condition is crucial to supporting a viable workers' compensation system for Montana businesses. It is because of our strong financial position, that we have been able to withstand the industry demands, and continue to service our customers effectively. For the sixth consecutive year, MSF issued a dividend to the employers of the State. Since 1998, $33 million has been returned to deserving policyholders.

The management and staff of MSF are very proud of our accomplishments in serving Montana businesses. We continually strive to improve our operations to ensure Montana businesses and the community will continue to benefit from a strong Montana State Fund many years into the future.

Sincerely,

Laurence Hubbard
President/CEO

Montana's insurance carrier of choice and industry leader in service